COMMENT & ANALYSIS: A tax cut that will discipline corporate America

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Economists and business leaders have stressed the tax policy benefits of President George W. Bush's "jobs and growth initiative". Ending the double taxation of corporate income, such as dividends, will lower the cost of capital and raise investment and job creation today while boosting productivity and wages for years to come. But on this, my last day at the White House, I want to make another argument for the plan that may be just as important.

The president's proposal will improve corporate governance by removing tax-based distortions from corporate decisions and by giving shareholders more information about their investments. One of the biggest distortions engendered by the current tax code is excessive corporate debt relative to equity, or "leverage". A second problem is a disturbing lack of transparency and accountability in some US corporations. The president's proposal will help solve both problems.

It is easy to see how excessive leverage is encouraged by the tax code. Corporate income from investment financed with debt is taxed only once, while income from equity-financed investment is taxed twice. Companies can write off interest payments on debt, thereby relieving the corporate level of tax for debt-financed projects. The interest income is then taxed when received by debt holders. In contrast, corporate income from equity-financed investment is generally taxed at the corporate level, then taxed again when paid out as dividends or eventually realized through capital gains.

You do not need an MBA to predict that corporations will rely on debt to finance new investment. Unfortunately, unlike dividend payments, interest payments cannot be suspended or reduced in bad times. Companies that cannot meet their interest payments risk bankruptcy, costly for both companies and creditors. As a result, the current tax code reduces the economy's ability to weather short-term fluctuations by increasing the number of business bankruptcies in recessions.

The problem of reduced transparency is more subtle but just as damaging. Because dividend payments face tax rates in effect as high as 60 per cent, the tax code is biased in favor of retaining earnings. Bad managers can exploit this incentive and use retained earnings for ill-advised investments or risky acquisitions, even when dividend payments would be in the best interest of the shareholders.

When companies have profitable investment and growth opportunities, retaining earnings is a good idea. But the crucial point is that business principles, not the tax code, should influence when earnings are retained and when they are remitted to shareholders.

Although the plan will end the tax bias against dividends, it does not create another bias against retained earnings. If a company decides to retain earnings, investors are allowed to adjust the basis of their shares, which reduces their capital gains taxes in the future.

This part of the president's plan allows the tax code to be "neutral" with respect to the company's decision to pay dividends or retain earnings - just as it should be. The economy is more efficient because supply and demand, not the tax code, determine the allocation of investment funds.

The proposal also increases transparency in financial reporting. Only earnings that have been taxed at the corporate level can be distributed as tax-free dividends. Because a shareholder's ability to exclude dividend income from tax is linked directly to the firm's tax payments, the plan allows investors to know exactly how much tax a firm has paid, something difficult to discern from many annual reports.

Giving investors more information is the best way to reduce corporate fraud. Think of the questions investors might ask if they were told that a company was paying no taxes while reporting hundreds of millions of dollars in operating income.

By leveling the playing field between debt and equity finance, removing taxes from the decision to retain earnings or pay dividends and providing investors with more information, the plan will improve American corporate governance. Investment will be stimulated by this improvement as well as by the reduction in the cost of capital. With higher investment will come more jobs and higher productivity and wages. In short, the benefits of the plan stretch from the boardroom to the shop floor, making it the right policy to help the economy now.

The writer today leaves the post of chairman of the US president's Council of Economic Advisers